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The Effects of Western Trade Concessions to Poland and Hungary [redacted] 25X1

Summary

Prospective trade concessions by the United States and the European Community probably will not substantially increase Polish and Hungarian exports in the next few years, but could improve these countries' hard currency earnings by the mid-1990s if Warsaw and Budapest carry out their economic reforms. Inability to quickly increase the production of marketable goods will probably prevent the East Europeans from taking full advantage of better market access in the next few years, limiting annual export increases directly attributable to these concessions to $110-130 million for Hungary and $145-165 million for Poland (at constant prices). These gains probably will have little impact on growth in Western direct investment in these economies. If Polish and Hungarian reforms improve these countries' competitiveness and orientation to world markets, we believe the export increases will probably reach $1 billion for Hungary and $3-4 billion for Poland by the late 1990s. [redacted] 25X1

This typescript was prepared by [redacted] 25X1
[redacted] Office of European Analysis. Comments and queries are welcome and may be directed to the Chief, Issues and Applications Division, EURA, [redacted] 25X1 25X1

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Discussion

The near term gains for Poland and Hungary from trade liberalization by the West--the elimination of EC quotas applied to state-trading countries combined with the granting of GSP status by the United States and the EC--will be small. We forecast that the boost to existing annual export growth directly attributable to these concessions would be only about $110-130 million for Hungary (about $90 million to EC markets) and $145-165 million for Poland (about $125 million to the EC) in the next two years. We do not believe these increases by themselves will substantially affect direct investment from the West.

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The principal obstacle to large gains in hard currency exports for Poland and Hungary lies in their inability to increase quickly the production of goods marketable in the West. Their efforts in recent years to boost hard-currency exports have probably brought these economies close to their capacity limits until they complete a substantial economic rationalization which may take a decade or longer. Poor investment policies--coupled with the chronic inflexibility of these economies--leave them little scope for shifting production to take advantage of new market opportunities. Longstanding problems with product quality, marketing, and service also will continue to plague their export efforts. Moreover, Community imports of several of these countries' most important exports--coal, steel, textiles, and certain agricultural products--are either not covered by the EC's GSP program or probably will continue to be restricted by quotas applied to market economies.

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We believe the benefits of GSP status and relief from specific quotas are too small to encourage many more Western firms to invest in these countries over the next few years. Other considerations--such as political stability, management control, and ability repatriate profits in hard currency--are probably much more important in the decision-making of businessmen. In addition, Western investors in Eastern Europe generally are more interested in gaining entry to the Soviet bloc market than in exports to the West. If any effect were felt, Hungary would almost certainly benefit more than Poland because of a more positive climate for Western businessmen. 25X1

The payoff from Western trade concessions would be much more substantial in the medium to long term if planned reforms restructure these economies, increase competitiveness, and produce a stronger orientation to world markets among domestic producers. Our methodology indicates Hungary's additional exports to the US and EC as a result of the trade concessions could top $1 billion annually by the late 1990s (see Appendix). Because it has a much larger economy and probably more potential for raising hard-currency exports, Poland's export gains could approach $7 billion, according to our methodology, presuming substantial progress on economic reforms, but given the major inefficiencies and lack of

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export-orientation in Poland, we believe the export increases will probably be on the order of $3-4 billion at most. We also believe it will take Poland much longer to reap the full gains than Hungary. [redacted] 25X1

Appendix

Methodological Note

Demand conditions in Western Europe are such that Poland and Hungary have the potential to capture large gains in sales for many of their exports to the European Community. Hungarian and Polish goods typically comprise less than three percent of total EC imports in any given product (3-digit SITC) category. Accordingly, EC demand for Polish and Hungarian exports--as a substitute for other countries' exports--should be highly price elastic. Even though the price advantages of duty-free GSP status are limited by the fact that EC tariffs are already relatively low, the potential increase in EC demand for Polish and Hungarian export-quality goods is probably substantial relative to current export volumes. 25X1

We believe, however, that except in a few sectors not likely to be liberalized by the EC (coal, meat, live animals, for example), neither country has the capacity to meet this potential demand. Accordingly, supply constraints will determine the amount of additional exports each country is able to gain from the trade concessions offered by the US and EC. 25X1

Because of longstanding inefficiencies and the likelihood that recent export pushes have nearly exhausted the potential for further rapid export growth, we believe neither country could increase its exports to the West in response to trade concessions by more than five percent during the next two years. After excluding sectors we believe will continue to be constrained by quantitative restrictions, this suggests a near-term upper limit of about $100 million for Hungary and $125 million for Poland. 25X1

Over the longer term, after substantial restructuring and greater marketing experience, we believe both Poland and Hungary could match Yugoslavia's degree of penetration of EC markets. All three countries have reached roughly similar levels of development, although Yugoslavia has progressed further toward a market economy and has more extensive trade ties to the West. It has, for example, long enjoyed GSP status with the EC and freedom from a number of the quotas that restrict Polish and Hungarian trade. As Poland and Hungary reform and re-orient their production and trading patterns toward hard-currency markets, they could raise the fraction of their domestic product that is exported to the EC to Yugoslavia's--4.1% in 1987. Using 1987 GDP and trade data, Hungarian exports could rise by about $1 billion. Polish exports could eventually rise to $10 billion--an increase of about $7 billion over 1987. We do not believe, however, that Poland is likely achieve the requisite restructuring before the end of the century. Accordingly, we estimate potential Polish gains by the late 1990s at $3-4 billion. 25X1